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MEXICO RURAL ECONOMY STRATEGY
Rural Financial Markets in Mexico: Issues and Options

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Submitted by:
Chemonics International Inc.
1133 20th St., NW • Washington, DC • 20036
Phone: 202-955-3300
Fax: 202-955-3400
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ACRONYMS

AMAP	Accelerated Microenterprise Advancement Project
ANAGSA	Aseguradora Nacional Agrícola y Ganadera, S.A.
BANRURAL	Banco Nacional de Crédito Rural
BANSEFI	Banco de Ahorro Nacional y Servicios Financieros
BASIS	Broadening Access and Strengthening Input Market Systems
CNBV	Comisión Nacional Bancaria y de Valores
DGRV	German Confederation of Raiffeisen Cooperatives
EACP	Entidades de Ahorro y Crédito Popular
FEFA	Fondo Especial para Financiamientos Agropecuarios
FEGA	Fondo Especial de Asistencia Técnica y Garantía para Créditos Agropecuarios
FINCA	Foundation for International Community Assistance
FINCAS	Fondos de Inversión y Contingencia para el Desarrollo Rural
FIRA	Fideicomisos Instituidos en Relación con la Agricultura
FONAES	Fondo Nacional de Apoyo para las Empresas de Solidaridad
FONDO	Fondo de Garantía y Fomento para la Agricultura, Ganadería y Avicultura
FOPESCA	Fondo de Garantía y Fomento para las Actividades Pesqueras
NAFTA	North American Free Trade Agreement
PAHNAL	Patronato del Ahorro Nacional
PATMIR	Proyecto Regional de Asistencia Técnica al Financiamiento Rural
PROCAMPO	Programa de Apoyos Directos al Campo
PROCREA	Programa de Crédito en Administración
PRONAFIM	Programa Nacional de Financiamiento de Micro Empresarios
SAGARPA	Secretaría de Agricultura, Ganadería, Desarrollo Rural, Pesca y Alimentación
SE	Secretaría de Economía
SEDESOL	Secretaría de Desarrollo Social
SIEBAN	Sistema de Estímulos a la Banca

SIESUC	Sistema de Estímulos a las Uniones de Crédito
SOFOLES	Sociedades Financieras de Objeto Limitado
USAID	U.S. Agency for International Development
WOCCU	World Council of Credit Unions

MEXICO RURAL ECONOMY STRATEGY

Rural Financial Markets in Mexico: Issues and Options

by
Claudio Gonzalez-Vega[1]

The Challenge

The purpose of this brief —on issues and options for improving rural financial markets in Mexico— is to offer guidelines to the U.S. Agency for International Development (USAID/Mexico) on how to move forward and ambitiously build, from its current microfinance activities, a robust rural finance program. With a robust program, USAID/Mexico would have the opportunity to significantly contribute to the deepening of financial markets in the rural areas of Mexico, while complementing the on-going efforts of multilateral development banks (in particular, the World Bank and the Inter-American Development Bank [IDB]), several agencies of the Mexican Government, and a variety of nongovernment initiatives.

The task of financial deepening in rural Mexico is enormous. While USAID can make important contributions to bringing about some of the required changes in policies, organizations, and financial technologies, every one of the actors with an interest in the sector will have to face the issues and options discussed here. Given the magnitude and complexity of the challenges and the number of actors present, there can be major gains simply from more effective coordination. In this setting, USAID/Mexico can play an important catalytic role.

USAID/Mexico currently confronts a unique opportunity to influence policymaking, institution building, and rural financial market development in Mexico in ways that are more than proportional to the funding needed to build a more robust USAID microfinance and rural finance program. At the same time, given a number of risks, USAID must overcome important threats to the success of the effort.

Several factors support an optimistic prognosis. First, the central challenge in promoting financial deepening and in strengthening rural financial markets in Mexico is not a scarcity of funds. Funds are not necessarily lacking in Mexico—at least at this stage. Actually:

[1] Claudio Gonzalez-Vega is Professor in the Department of Agricultural, Environmental, and Development Economics and Director of the Rural Finance Program at The Ohio State University. This brief was prepared under contract from MUCIA, in collaboration with the RAISE consortium led by Chemonics International. Issues and options were identified during a trip to Mexico on 12-19 March 2004. The author thanks the other team members—Jolyne Sanjak, David Bathrick, and Tom Reardon—for their stimulating interaction, and Jeremy Smith, USAID, for his meticulous guidance. Jeremy organized the ambitious and comprehensive schedule of visits that made this brief possible. The author thanks the support of other USAID staff and the helpful hospitality of the numerous Mexican authorities, academics, and practitioners interviewed during the visit. A list of all persons interviewed outside of USAID can be found in Annex A. The views expressed here are solely those of the author; moreover, these views reflect only a preliminary and rapid assessment, based on interviews, secondary data, and stylized perceptions. Inevitably, there will be errors of perspective and of omission. Comments are most welcome.

- The Mexican Government has been channeling considerable amounts of public-sector funds to rural credit programs and other financial interventions, through organizations such as the *Fideicomisos Instituidos en Relación con la Agricultura* (FIRA), the *Financiera Rural, and* the *Banco de Ahorro Nacional y Servicios Financieros* (BANSEFI) as well as through several departments of the Executive — the *Secretaría de Agricultura, Ganadería, Desarrollo Rural, Pesca y Alimentación* [SAGARPA], the *Secretaría de Desarrollo Social* [SEDESOL], and the *Secretaría de Economía* [SE], among many others.

- Major international donors, among them the World Bank, the IDB, and the Ford Foundation, have focused comparatively large programs on dimensions of rural and development finance. The multilateral organizations have hired consulting agents and have worked through government offices; other donors collaborate with nongovernmental organizations (NGOs) as well.

- Substantial amounts of funds reach the rural areas in Mexico from outside these areas, through private channels (for example, remittances) and public-sector subsidies and welfare programs (including, among others, *Programa de Apoyos Directos al Campo* [PROCAMPO] and *Alianza Contigo*). In addition to local savings, these funds from outside contribute to available liquidity in the rural areas.

Thus, the central issue in the rural areas of Mexico is not necessarily a scarcity of funds but rather the absence of sustainable and efficiently supplied financial services, including but not exclusively credit, that are available at reasonable terms and conditions to broad segments of the population. Loan funds, *per se*, are not services. It is financial *services* rather than funds, however, that matter as intermediate inputs in the management of intertemporal choices (that is, savings and investment decisions), the reduction of transaction costs, and the accumulation of speculative and precautionary liquid reserves and deployment of other risk-coping and consumption-smoothing strategies for both households and firms.

Financial intermediation is shallow in Mexico, in general, and efficiently supplied financial services are particularly rare in rural Mexico. Key indicators of financial deepening are low (for example, the ratio of domestic credit for the private sector to the gross domestic product) in comparison to countries with similar-sized economies and similar levels of development. Unsatisfied demands for various types of financial services, particularly in the rural areas, reflect less the scarcity of loanable funds and much more the insufficient mechanisms for financial intermediation available. Yet, financial intermediation is what matters for the beneficial effects on resource allocation, capital accumulation, and stabilization of income and consumption expected from financial deepening.

Thus, in Mexico, the rural lag in financial deepening is substantial. The supply of all types of financial services is thin and narrow in the rural areas. The proportion of households and their agricultural and non-agricultural enterprises that enjoy access to financial services provided by both formal and semiformal financial organizations, as well as by several types of non-financial agents, is low.

Those financial services that have been available in rural areas (as, at times, with the BANRURAL programs of the past) have been less reliable, less sustainable, and less flexible —in their ability to respond to legitimate demands from the clients, who seek financial contract terms and conditions that match their circumstances— as well as more costly for all participants (depositors, lenders, borrowers and others) than in urban financial markets in Mexico and in other developing countries in general.

While there is widespread consensus about the dearth of financial services in rural areas in Mexico, there is limited understanding of the reason for it. Recognition of the basic reality that loan funds are not intermediation services is critical for at least three reasons:

- Shortcomings in the supply of financial services cannot be overcome simply with larger flows of funds, any more than flooding would substitute for carefully managed irrigation. In fact, a large inundation of loan funds (*un derrame*, as such programs are often described in Mexico), in the absence of institutional capacity to manage them, usually impedes the development of management capacity.

- Many of the complaints about credit starvation in the rural areas fail to recognize the actual sources of problems related to productivity, income generation, investment, and competitiveness. Instead, it is assumed at least implicitly that credit is a panacea —which it is not— and that it may be a powerful tool to address such problems. From this perspective, loan funds will always be inadequate. The challenges are, on the one hand, to identify instances where legitimate demands for credit are not being satisfied, in order to expand the supply of funds, and, on the other hand, to make sure that attention is not being shifted away from solving nonfinancial problems that cannot be corrected with credit. Using credit for the latter purposes usually has counterproductive effects.

- Unqualified claims about the scarcity of loan funds in the rural areas also divert attention from deposit mobilization and from the limited supply of other financial services that are critically important for the rural population.

Second, the key issue in Mexico is not the scarcity of programs that would have, at one time or another, attempted to disburse loans to the rural population. Actually, one of the main challenges is that there are *too many* programs and interventions, often inconsistent and unsustainable, that have accumulated over the years as new interventions have been designed and implemented without eliminating old programs. The challenges for the authorities, therefore, are not only to design the appropriate interventions to promote rural financial deepening but also to make sure that existing activities and the distortions that accompany them will not undermine the success of the new activities.

Beyond introducing new interventions and designing new programs, therefore, it is necessary to meet a challenge of consistency. This will require the USAID/Mexico program to look beyond its own specific activities and consider the implications of what is happening in other areas.

Historically in Mexico, there has been no absence of "creativity" in formulating programs, though there has been less attention to their efficiency and sustainability. The major challenge today, however, is the absence of sustainable specialized financial intermediaries, with a vocation to working in the rural areas and with knowledge about financial technologies—criteria, steps, procedures, tools, and the like—that make their operations cost-effective. Creating organizations and programs is not enough to develop and ensure a sustainable rural supply of financial services.

Third, there has been no shortage of special incentives —in particular, explicit and implicit subsidies— as part of numerous attempts to encourage various types of organizations to deliver credit in the rural areas in Mexico. FIRA, for example, has experimented with several generations of approaches to induce both banks and non-bank organizations to lend for particular purposes in specific regions.[2] FIRA services have included rediscounting facilities for agricultural and rural portfolios, credit guarantees, and a wide range of subsidies and other inducements for participating intermediaries (mostly banks) as well as for the final borrowers. Some of these programs, such as the *Sistema de Estímulo a la Banca* (SIEBAN) and the *Sistema de Estímulos a las Uniones de Crédito* (SIESUC), have attempted to compensate financial intermediaries for the costs of screening, monitoring, and other information management activities related to small transactions. At best, the results have been mixed, and there has been concern that supply would immediately contract if FIRA were to remove its incentives.

Rather than stimulating supply, excessive compensation has in fact discouraged innovation and created unsustainable outreach. Because the incentives have not always recognized the actual reasons for the shortcomings in the rural supply of financial services, they have been comparatively ineffective. Indeed, incentives have been designed on the assumption that without them the supply of rural financial services cannot be expanded. This has been a self-fulfilling prophecy: True innovations have been slow to come because the environment is distorted. In the absence of true innovation, it will not be possible to expand the supply of rural financial services in a substainable manner.

Both in attempts to further expand the frontier of rural finance and in efforts to disburse larger shares of its massive availability of funds, FIRA has put in place incentive programs for non-financial organizations (the *agentes parafinancieros,* which are non-financial enterprises with advantages to disburse loans locally). While non-financial agents that operate along productive chains can play a valuable role in wholesale-retail financial arrangements, their services are restricted to specific inputs and crops; they do not encourage generalized financial intermediation. The *Programa de Crédito en Administración* (PROCREA) has enlisted a number of specialized offices (*despachos*), used as a mechanism to facilitate access of new, previously excluded, clients to bank credit. To facilitate the activities of these agents, FIRA has recently regulated the operations of *Sociedades Financieras de Objeto Limitado* (SOFOLES).

[2] FIRA consists of four trust funds (*fideicomisos*) that coordinate their activities: the Fondo de Garantía y Fomento para la Agricultura, Ganadería y Avicultura [Fondo]; Fondo Especial para Financiamientos Agropecuarios [FEFA]; Fondo Especial de Asistencia Técnica y Garantía para Créditos Agropecuarios [FEGA]; and Fondo de Garantía y Fomento para las Actividades Pesqueras [FOPESCA].

There are partial successes and some failures in the attempts of these programs to expand the number and variety of actors that supply rural credit. Promotion of a broad set of supply arrangements is highly desirable, indeed, for mobilizing the comparative advantages of different types of agents in various market segments. In the end, however, despite the massive amounts of funds so far expended, the cost-benefit results of these efforts have not been entirely favorable. The incentives have failed to induce a sustainable supply of financial intermediation services, not just credit, in the rural areas of Mexico.

Among the most controversial of FIRA's interventions have been its guarantee mechanisms. Traditional and non-traditional credit guarantees have been used in the attempt to share the risk of credit transactions between the banks and FIRA (that is, Mexican society). With the promotion of *Fondos de Inversión y Contingencia para el Desarrollo Rural* (FINCAS), the organization has further attempted to induce financial intermediaries to lend to low-income rural clients, by insuring them against a number of risks. Particularly where they have been excessive, these guarantees have encouraged the very moral hazard they are supposed to compensate for.

The most important legacy of all of these interventions has been the absurd absence of any serious concern about risk in these segments of the Mexican financial system. As the Mexican state has made itself the credit insurer of last resort, market suppliers have had no incentive to invest in innovations that would facilitate the management of credit risk or to learn how to recognize and deal with different types of risk.

In summary, until there is an accurate diagnosis and a clear understanding of the role of financial services and of the difficulties of supplying these services in rural areas, additional funds, additional organizations, and additional incentives will not expand the frontier of financial services into rural Mexico.

Precisely because its own funding is limited, however, USAID confronts a unique opportunity to influence policymaking, institution building, and development of rural financial markets in Mexico. This could be done by, among other things, helping other actors to better focusing their attention on key binding constraints to further expansion of the frontier. The minimum mass and excellent quality of a robust program will be needed, nevertheless, to accomplish this. Although limited, the USAID/Mexico funds should turn out to be attractive even for major players, because these funds will be truly additional for the rural finance sector. In contrast to World Bank and IDB funds, which replace existing line items in the Mexican federal budget, USAID funds would actually increase the volume of resources available. Further, it will be possible to deploy these resources through public and private actors with greater flexibility than has been possible with other channels.

In particular, a robust USAID/Mexico rural finance program can generate valuable externalities and influential demonstration effects. These spillover effects will be stronger as long as there are both steady improvements in the environment for the operation of rural financial intermediaries and receptive potential partners. Both of these currently exist in Mexico. As to the environment, several recent important institutional reforms represent major steps in the right direction. As for partners, the cadres of competent managers and professionals in several of the organizations visited gave clear indication of their willingness to work with a robust USAID program.

From this perspective, the USAID/Mexico program could strengthen the hand of reformers while capturing the minds of the rest. Undertaken systematically and carefully, a well-funded *knowledge-oriented* activity (rather than another large influx of loanable funds) could be extremely influential. There are several reasons for this optimism.

First, the general environment for rural finance has been improving. For several decades, the Mexican government, more than any other at least in Latin America, attempted to implement every possible dimension of a protectionist approach to rural finance. The cost-benefit outcome of these interventions was quite unfavorable. The fiscal costs were high and the contingent liabilities for the Mexican Government from the operations of several state-owned organizations were alarming. The resulting distortions caused major losses in efficiency in several sectors. Worse, these interventions inhibited the kinds of innovations that in other countries have made it possible to extend financial services to previously excluded clienteles in ways that none of these costly interventions has been able to accomplish in Mexico.

The Mexican authorities have been increasingly aware of these issues; they understand many of the threats that could arise from the continuation of this approach and have attempted to reform the traditional system. This has not been easy —the task is still very incomplete— but a new institutional environment for state intervention in rural finance has been gradually emerging, one that will be more receptive to the contributions of an expanded USAID/Mexico program than the previous state of affairs:

- A new legal framework (*Ley de Ahorro y Crédito Popular*) was adopted in an attempt to bring order and transparency to a sector characterized by an overwhelming variety of organizations, major ambiguities about their role and operations, and limited accountability. The *Reglas de Carácter General* issued in late 2002 defined four levels of operation for the *Entidades de Ahorro y Crédito Popular* (EACPs), based on their assets, number of clients, and geographical outreach.

  One central challenge in Mexico has been precisely to introduce more uniform rules of the game and to level the playing fields. This particular legislation has accomplished these goals to some extent, although several experts have identified potential shortcomings. Some of them have been particularly concerned with the effectiveness of the system of delegated supervision introduced by the law, which creates a major role for federations of EACPs, as described below. Nevertheless, despite several advantages and disadvantages of the resulting arrangements and the intense (and continuing) political controversy, this legislation, to which USAID/Mexico contributed, is an important step forward.

  Unfortunately, while the law has created a framework for institution building, little progress has been made in implementing it. A robust USAID/Mexico program could help move this process forward greatly, by directing efforts at the prudential authorities, the federations that will exercise auxiliary supervision, and the first-tier organizations to be incorporated into the regulated system.

- Specialized prudential supervision (the *Dirección General de Supervisión de Entidades de Ahorro y Crédito Popular* of the *Comisión Nacional Bancaria y de Valores* [CNBV]) has been strengthened, also with USAID support , by investments in human capital and technical assistance. While the CNBV has correctly retained ultimate responsibility for the stability and efficiency of the network of EACPs, in accordance with the law, it has enlisted the auxiliary prudential supervision of special committees, attached to federations of EACPs. With the consulting assistance of WOCCU, the Canadian network Des Jardins, and the German DGRV, several federations and committees have been created and/or strengthened. The greatest challenge that remains is at the first-tier level, where a multitude of heterogeneous financial organizations —some strong and many weak, diverse, and dispersed— operate under conditions that have often not catalyzed the necessary financial discipline.

- State-owned second-tier interventions have been reformed to create organizational designs that reverse the major deficiencies of earlier programs. Of particular interest here has been the replacement of the *Patronato del Ahorro Nacional* (PAHNAL) by BANSEFI. Similarly important has been —finally— the closing of the infamous BANRURAL and its replacement by the *Financiera Rural*. For Mexico, this has been a monumental step. Major innovations in institutional design have been that the new rural finance organization will not have access to the fiscal accounts (thereby constraining potential opportunistic behavior) and that incentives compatible with the sustainability of the organization have been created, by requiring that its costs of operation be covered with earnings on its fixed endowment. Both BANSEFI and *Financiera Rural* currently operate at both the first- and second-tier levels. This dual role has created potential conflicts of interest, but the intention is to make these organizations exclusively second-tier operations within a reasonable time.

  These institutional reforms have been equivalent to the closing of the *Aseguradora Nacional Agrícola y Ganadera* [ANAGSA], the bankrupt state-owned crop insurance organization, and its replacement by AGROASEMEX. Among other initiatives, the latter organization has been exploring the introduction of indexed insurance, which is not vulnerable to the adverse selection and moral hazard problems that plagued traditional crop insurance. Unfortunately, substantial subsidies are still channeled through its reinsurance programs.

- Some of the programs managed within departments of the Executive, in particular the *Proyecto Regional de Asistencia Técnica al Financiamiento Rural* (PATMIR) within SAGARPA, the *Programa Nacional de Financiamiento de Micro Empresarios* (PRONAFIM) at the SE, and perhaps to a lesser extent the *Fondo Nacional de Apoyo para las Empresas de Solidaridad* (FONAES) at the SE, reflect important changes in Mexican government policies. These programs have shown themselves somewhat willing to find cost-effective and nondistorting mechanisms to strengthen several types of viable non-governmental financial organizations. USAID/Mexico could complement this institution-building role.

- In addition to changes in the public sector institutional infrastructure for rural finance, the emergence of a few successful nongovernmental programs suggests the promise of innovative approaches to expanding microfinance and rural financial intermediation. Among these, the regulated microfinance organization *Compartamos* —which has received some USAID support— has been an outstanding example of how to develop these programs. There are several other examples of success by nongovernmental organizations.

Second, in this setting, a robust USAID/Mexico program would possess comparative advantages in the transfer of knowledge, institution building, and sector coordination. Indeed, globally, USAID has accompanied and supported several of the most successful experiments in microfinance and rural finance in other Latin American countries, such as Bolivia, Ecuador, El Salvador, and Peru. The success on Mexican ground of *Compartamos*, which shares many of the approaches and innovations of its Latin American cousins, strengthens this perception. Within the scope of their village banking activities, *Pro Mujer* and FINCA International have also attracted attention in Mexico.

Indeed, the Mexican academic and policymaking community has increasingly recognized that valuable lessons can be learned from these experiences, to complement the attention that the Canadian, German, and Spanish cooperative and savings bank movements have typically attracted there. The visits to representative academic and government organizations, associated with preparation of this brief, revealed substantial interest in these lessons among all types of actors. Mexican managers and professionals were avid for discussion of experiences elsewhere and of adjustments that might be required to make these approaches work in the Mexican environment. A robust USAID/Mexico program could offer this unique stock of knowledge as evidence of potential for fruitful collaboration.

Some risks and threats may also emerge in the development of a rural finance program by USAID/Mexico. First, diverse concerns motivate the current urgent calls for action regarding rural financial markets in Mexico:

- There is strong interest in increasing the competitiveness of Mexican agriculture. More efficient and reliable rural financial services are perceived as important in addressing the challenges and opportunities the agricultural sector faces in the NAFTA and post-NAFTA world and will increasingly face in the more competitive and integrated international and domestic markets of the future. There is a perceived need for financial services that better fit the requirements of a transforming agriculture and for the innovations in financial technologies that will make this possible.

- There is strong interest in alleviating rural poverty in Mexico; much of the incidence of poverty and the largest poverty gaps are found in rural areas, particularly in the south. Limited access to financial services constrains efforts to take advantage of opportunities for rural household-firms to increase and stabilize their incomes and to accelerate the formation of physical, human, and social capital.

- There is some interest in strengthening aggregate financial deepening. The spatial expansion of financial intermediation and the diversification of the asset and liability portfolios of financial intermediaries into agriculture and the rural areas would strengthen progress of the financial sector as a whole.

The opportunities and threats that emerge from this diversity of objectives must be kept clearly in mind in designing and implementing an expanded USAID/Mexico program and in any collective efforts to deepen rural financial markets in Mexico. The multiplicity of motivations creates the political challenge of addressing the concerns of varied and powerful constituencies. Historically, these concerns have been addressed in Mexico with a multitude of disconnected and often inconsistent interventions that mostly respond to rent-seeking pressures. The successful development of rural financial intermediation will require a more consistent and integrated approach.

At the same time, unique technical complexities in the supply of financial services emerge from the diverse difficulties and obstacles that must be overcome in addressing the challenges of responding to these different demands. Some of the obstacles relate, for instance, to the material conditions of agriculture, such as the seasonality of sowing and harvest cycles, vulnerability to weather and price shocks, the high covariance among production outcomes in a given area, and the heterogeneity of local conditions. Overcoming these obstacles will require customized lending and risk-management technologies.

Other obstacles relate to poverty, including the lack of separation of households from farm businesses, small transaction sizes, and the limited wealth of rural households, which do not own assets that are acceptable as traditional collateral. These features must be addressed with still other innovations in lending technologies, which address these particular constraints. Each challenge and objective calls for a different blend of expertise and experience.

While these technical challenges must be recognized, the most important contribution of an expanded USAID/Mexico rural finance and microfinance program would be the dissemination of basic principles and general lessons learned by USAID worldwide about best practices in expanding financial services to excluded clienteles.

Management of a larger USAID/Mexico program would be more challenging if it incorporated several of these diverse components, but such a program would achieve valuable synergies and economies of scope. Complications might arise in trying to overcome political and technical challenges because of the complexity of Mexican public administration and because Mexico is not a traditional USAID setting. Still, USAID success with the governance and rule of law programs suggest a relatively optimistic forecast for productive ways of working with the Mexican government on institutional reform.

Greater influence in the rural finance sector also presupposes that USAID/Mexico, while keeping its own identity and independence, will still be successful in collaborating with at least one of the major players in rural financial markets. This dimension of the expanded program would be ineffective, however, if the chosen partner should deviate from the principles and approaches that guide the program.

In collaborating with major Mexican counterparts, there is the potential moral hazard resulting from the electoral cycle (where short-term rather than long-term considerations may prevail), the mixed incentives that some key players confront (as in the potential conflict of interest of operating profitably both at the first- and second-tier levels), and the influence of other major donors and international agencies, which may not share the USAID approach to rural financial deepening.

While these threats are real, a USAID/Mexico program would be comparatively small (given the size of other donor-cum-government activities) and would have fewer opportunities to inflict irreversible damage than most of the existing interventions. If it were successful, however, the USAID program could make a decisive contribution to transforming rural financial markets in Mexico, from the protectionist perspectives of the past into a modern, innovation-based, and robust rural financial intermediation system.

To avoid missing the opportunity to exert a positive influence, the program will need to build significant technical authority and trust. It must demonstrate success in the field (particularly with specific institution-building efforts), and it needs the analytical capacity to explain the reasons for successes or failures. This implies that the expanded program must have access to diverse sources of high-quality technical assistance, strong research and analytical capacity, and flexible mechanisms for massive international transfers of knowledge.

The Response

An adequate supply of cost-effective and sustainable financial services matters in any process of rural development, both for greater domestic and international competitiveness and for broader participation in the fruits of specialization and trade. Efficient financial intermediation should play a central role, in particular, during periods of rapid structural transformation, when resources must be reallocated towards new profitable opportunities and when new risks and challenges of adjustment surface for all participants in both financial and non-financial markets.

In the case of Mexico, new demands for financial services are emerging from an accelerated process of structural transformation in the rural areas. For one subsector of the rural population —specialized medium to large agricultural enterprises and some efficient associations of small producers— greater participation in market value chains and closer integration to markets characterize the transformation. This process of specialization and formalization demands comparatively sophisticated financial services. The resulting productivity gains will contribute to rapid economic growth.

For another subsector of the rural population —household-farms— varying degrees of access to non-agricultural occupations and the development of small and microenterprises are making it possible to diversify their sources of income and to better manage idiosyncratic risks and uncertainty. A different set of demands for financial services emerge from such households. They demand a variety of comparatively simple services, such as safe and convenient savings deposit facilities, inexpensive mechanisms to transfer funds, and gradual access to several types of loans on improving terms and conditions.

Typical clients in this case are household-enterprises with a diversified portfolio of labor-supply allocations and of strategies to smooth income and consumption flows over time. The resulting productivity and risk-management gains here, too, will contribute to broader-based economic growth.

For a number of circumstances, the supply of financial services for both these subsectors in Mexico is inadequate, but an expanded USAID/Mexico program should concentrate on the second sub-sector, for several reasons:

1. Large Mexican commercial farmers already have access to the most basic financial services, even in international capital markets, while other sources of U.S. assistance can still contribute to the evolution of even more complex products and services.

2. USAID possesses comparative advantages in programs towards expanding the frontier of financial services to previously excluded populations.

3. FIRA and other Mexican programs already have deployed complex —though not necessarily efficient— ways to address the demands of large commercial farmers and enterprises; it would be almost impossible for USAID/Mexico to tackle detailed reforms of these programs. There are strong reasons for such reforms, but the USAID/Mexico program would only be able to influence them indirectly.

Massive government interventions in the first subsector of large commercial farmers do influence, however, the environment for expanding financial services to the second subsector of small household-farms. A robust USAID/Mexico program cannot ignore the adverse effects of these interventions. As a component of a well-focused policy dialogue, USAID/Mexico should promote elimination of the most harmful distortions that the protectionist programs have introduced.

To a greater or lesser extent, the dominant presence of the Mexican public sector in rural financial markets has resulted in bad policy and practices. While over time many of these practices have been gradually abandoned or replaced by less harmful interventions, their legacy is still visible in the operation of the system:

- The terms and conditions, including interest rates, and other rules of the game for financial transactions, particularly loans, have been determined by administrative —and political— decisions. These controls have segmented financial markets and discouraged innovation.

- Financial services (mostly credit) have been provided through state-owned development banks and other government programs, many of which have been housed in departments of the Executive that are not specialized in financial intermediation. This has lowered the credibility of credit contracts, through perceptions of political handouts, and has jeopardized the collection of loans.

- A broad range of additional government organizations have been created to support subsidized and directed credit programs. At the same time, the most basic institutional infrastructure required for the smooth operation of financial markets is not yet in place. The missing infrastructure includes the definition and protection of full property rights to land, mechanisms for writing and enforcing contracts, and instruments, such as credit bureaus, that contribute to universal access to information on indebtedness. Strengthening the physical and institutional infrastructure is indispensable for lowering transaction costs and for the smooth operation of financial markets.

- There is an almost exclusive focus on the provision of credit, to the neglect of other types of financial services. Massive injections of loans and subsidies are no substitute for deposit facilities.

- Both the risks implicit in financial transactions and the need for cost-effective mechanisms to address risk have been excessively ignored. Instead, the state has consented to be the risk-taker of last resort, thus indirectly promoting excessive moral hazard in the system.

- Narrowly directed credit programs are focused on agriculture and targeted to particular “priority” crops. This approach has ignored both the fungibility of funds and the complexity of household portfolios and livelihood strategies. More importantly, this approach ignores the deep and rapid process of structural transformation that is occurring in the Mexican rural areas. As a result, the programs are not meeting legitimate demands for varied financial services that accompany this structural transformation.

In Mexico, as in many other developing countries, the conditionality imposed by some international donors and other funding agencies, including interest rate and directed credit requirements, often reinforce these bad practices. In making large amounts of funds available at less than market terms, these programs have also discouraged domestic savings mobilization. Pressured to disburse loan funds, beneficiary organizations have had less incentive to offer other types of financial services.

More importantly, in ignoring whether the organizations being funded are sustainable or not, these programs have undermined the robustness of the rural financial system. Generous funding of non-sustainable organizations has in turn crowded out other, more sustainable, intermediaries that would have been willing to offer a broader menu of financial services to the rural population. Because the playing field has not been level, weak organizations have gained an artificial competitive edge over other intermediaries with more genuine comparative advantages in delivering a broad range of financial services to the target population. When these weaker organizations have shown less energy in enforcing contracts and collecting loans, the culture of repayment as a whole has been undermined. These counterproductive interventions have undermined the deepening of rural financial markets in other developing countries where such donors have played a major role.

In general, a broader financial intermediation perspective is urgently needed in Mexico. The main objective of a more robust USAID/Mexico rural finance program should be to contribute to molding and strengthening this new perspective. While the importance of this approach is clear, implementing it will not be easy, for several reasons.

First, the Mexican authorities have discouraged financial intermediation by state-owned organizations. Thus, BANSEFI is fully specialized in providing deposit and other liquidity management services; it cannot grant loans. The *Financiera Rural* is fully specialized in credit; it cannot mobilize deposits from the public.

The perspective of the Mexican authorities is correct in the case of state-owned institutions, for several reasons:

- From the fiscal perspective of the *Secretaría de Hacienda y Crédito Público*, the assumption of the contingent liabilities resulting from the poor portfolio performance of state-owned intermediaries (clearly illustrated by the lessons of history) is incompatible with the healthy budgetary and public debt policy to which USAID has also contributed.

- From the monetary perspective of the *Banco de México*, the mobilization of deposits from the public by not-fully-accountable financial intermediaries threatens the stability of the financial system. Further, the CNBV would find it difficult to deal with the political pressures resulting from poor portfolio performance by state-owned organizations that mobilized deposits.

Together, the significant share of foreign ownership of private commercial banks, their perception of the political risks of expanding their credit portfolios to members of powerful constituencies, and the attractive availability of public-sector securities result in a comparatively small proportion of loans to total private bank assets. Focused on earning fees on services, the private banks are not contributing enough to financial intermediation. Paradoxically, therefore, some of the most promising opportunities for increased financial intermediation in Mexico can be found in non-banking sectors that do not cater to corporate clients. The role of non-banking intermediaries has also been critical in other countries. This is the segment of the market where a robust USAID/Mexico program could have an important influence.

Despite their specialization and thus their minimal contribution to financial intermediation, BANSEFI and *Financiera Rural* are the most important actors in this segment of the market. They possess valuable stocks of human capital and strong willingness to innovate and to increase their efficiency. They are natural candidates for partnership with an expanded USAID/Mexico program that could help solve one of the most basic dilemmas these organizations encounter.

On the one hand, they are supposed to move rapidly to a second-tier level but there are too few organizations at the first tier for them to leave that segment or help them dilute their fixed costs. They are at present like large and sophisticated superstructures on weak foundations. On the other hand, the new structure of compatible incentives to encourage sustainability has forced them to operate, at least for the time being, at the first-tier level, in direct competition with the very organizations that are supposed to become their future clients.

There is a need to overcome this conflict of interests. The most effective way to accomplish this will be to strengthen first-tier organizations further. USAID/Mexico, with its comparative advantages in institution building, can contribute with templates for the restructuring and growth of successful financial organizations of several types.

Strengthening first-tier organizations is also a precondition for forming robust federations of EACPs and setting up competent independent supervision committees. This will be indispensable if the *Ley de Ahorro y Crédito Popular* is to be implemented successfully.

A more robust set of first-tier organizations will have two consequences:

1. It will help create a clientele for the broad range of services that BANSEFI will be in a position to offer.

2. It will make feasible the new prudential supervision role of the CNBV, which has a historical orientation toward banks.

Setting up functioning specialized prudential supervision will not be easy, but current USAID/Mexico support and strong Mexican interest have already accomplished a lot. CNBV will need additional assistance to create the operational capacity to implement the principles that have been already adopted and the regulation that has been enacted. While the law, yet to be implemented, has already been revised at least three times, it is urgent that there be intensive learning-by-doing at all levels of the system. While committees and federations are expected to offer auxiliary supervision —they should be strengthened to do this— the CNBV must learn to identify risk at the first-tier level, not simply to regulate and monitor the formation of second-tier institutions.

Rapid development of the first tier will depend strongly on receptiveness in Mexico to adaptable ideas from outside. In addition to the demonstration effects from innovative experiments like *Compartamos*, a massive program of technology and best-practices transfers will be needed. The goals of this program could be achieved by the frequent presence in Mexico of highly competent practitioners from elsewhere and by observation trips and internships for Mexicans abroad. USAID can rely on its broad worldwide network and successful experiences to supply the talent and opportunities for such transfers and exchanges.

Good applied research and analysis must undergird new conceptual frameworks that facilitate understanding, adoption, and adaptation of the new knowledge. Interactions with the USAID AMAP knowledge generation activities and the BASIS rural finance program could bring additional synergies. What is needed is a transformation of how financial innovations are understood in Mexico. That is, there is a need for innovation in the way in which innovations are generated and disseminated. This implies, among other things, new ways to think about the role of the public sector in the promotion of rural financial deepening. Thus, one of the central goals of the expanded USAID/Mexico rural finance program would be to introduce innovations into the innovating process itself.

Because of the network of relationships already built by the USAID/Mexico microfinance program and the potential for the transfer of lessons learned in microfinance activities to deepen rural financial markets, there are also valuable opportunities for collaboration with PRONAFIM and PATMIR. Cooperation with the World Bank program implemented through the German Savings Banks Foundation assistance could also create interesting spaces for support of some of the *cajas solidarias* **[**associated with FONAES.

Yet, while necessary, such system-wide activities will not be sufficient. To gain credibility, USAID/Mexico must select a few first-tier cases for intensive institution building efforts. Because there is an excess demand in Mexico for direct technical assistance, these experiments must be chosen carefully, from both regulated and non-regulated types of organizations. Despite the limitations of size and the concentrated risks of the new rural banks, for example, there may even be opportunities to assist in institution building there, at the lowest links in the rural financial intermediation chain. In the end, only through learning-by-doing with an open mind will it be possible to find out what does and does not work in Mexico.

ANNEX A

Interviews outside USAID

- Luis Javier Akle Fierro
  Sub-Secretario de Planeación Agraria
  Secretaría de la Reforma Agraria

- Carlos Alba
  International Consulting Consortium, Inc. (ICC)
  Miami

- José Luis Alcántara Ramírez
  Residente Estatal
  Fideicomisos Instituidos en Relación con la Agricultura (FIRA)

- Rayo Angulo Sánchez
  Asesor del Secretario
  Secretaría de Hacienda y Crédito Público

- Norma Arellano Uribe
  Consejo Latinoamericano para la Capacitación en Microfinanciamiento (COLCAMI)

- Juan Buchenau
  Frontier Finance Internacional,
  Washington, D.C. (by phone)

- Javier Cárdenas Felix
  Director de Cajas Solidarias
  Dirección General de Fondos y Microempresas
  Secretaría de Economía

- Rodolfo Cermeño
  Profesor
  Centro de Investigación y Docencia Económicas (CIDE)

- Pablo Cotler Avalos
  Profesor
  Universidad Iberoamericana

- Isabel Cruz Hernández
  Directora General
  Asociación Mexicana de Uniones de Crédito del Sector Social (AMUCSS)

- María del Carmen Díaz
  Directora
  Programa Nacional de Financiamiento de Micro Empresarios (PRONAFIM)
  Secretaría de Economía

- Luis Heriberto García Muñiz
  Fortalecimiento y Desarrollo Institucional
  Programa Nacional de Financiamiento de Micro Empresarios (PRONAFIM)
  Secretaría de Economía

- Alonso García Tamés
  Subsecretario de Hacienda y Crédito Público
  Secretaría de Hacienda y Crédito Público

- Javier Gavito Mohar
  Director General
  Banco de Ahorro Nacional y Servicios Financieros (BANSEFI)

- Francisco Gil Díaz
  Secretario de Hacienda y Crédito Público
  Secretaría de Hacienda y Crédito Público

- Jaime González Aguadé
  Director General Adjunto de Operaciones y Programas
  Financiera Rural

- Ursula Heimann
  Directora de Oficina de Representación
  Fundación Alemana de Cajas de Ahorro

- Oscar Hernández Sánchez
  Promotor, Agencia de Toluca,
  Fideicomisos Instituidos en Relación con la Agricultura (FIRA)

- Fausto Hernández Trigo
  Profesor
  Centro de Investigación y Docencia Económicas (CIDE)

- John Kellenberg
  Gerente, Sector de Desarrollo Rural y Medio Ambiente
  World Bank, Mexico

- Janina León
  Profesor
  Universidad Iberoamericana

- Luis Felipe Mariscal
  Director General de Supervisión de Entidades de Ahorro y Crédito Popular
  Comisión Nacional Bancaria y de Valores (CNBV)

- José Antonio Meade Kuribreña
  Director General
  Financiera Rural

- Carlos Montemayor
  Director General de Seguimiento
  Secretaría de Desarrollo Social (SEDESOL)

- Roberto Moya Clemente
  Director General Adjunto de Promoción
  Financiera Rural

- David Myhre
  Asesor de Programas, Finanzas para el Desarrollo y la Seguridad Económica
  Ford Foundation

- Juan José Navarrete
  Sub-Director de Capacitación y Enlace
  Banco de Ahorro Nacional y Servicios Financieros (BANSEFI)

- Guillermo Ortiz Martínez
  Gobernador
  Banco de México

- Gonzalo Puente
  Director Ejecutivo
  FINCA International, México

- Mauricio Ramírez Grájeda
  FONAE (earlier)

- Guillermina Rodríguez Licea
  Estudios Económicos
  Grupo Financiero BANAMEX

- Antonio Sánchez Díaz de Rivera
  Subsecretario de Desarrollo Social y Humano
  Secretaría de Desarrollo Social (SEDESOL)

- Ricardo Skertchli
  Consejo Latinoamericano para la Capacitación en Microfinanciamiento (COLCAMI)

- Víctor Manuel Sosa Estrada
  Agente
  FIRA

- Sergio Soto Priante
  Coordinador General de Micro Regiones
  Secretaría de Desarrollo Social (SEDESOL)

- Francisco Suárez Mogollón
  Subdirector de Promoción de Proyectos Productivos
  Financiera Rural

- Liza Taber
  The World Bank, Washington, D.C. (by phone)

- Juan Manuel Valle Pereña
  Director Ejecutivo de Programas y Productos
  Financiera Rural

- Alejandro Vázquez Salido
  Asesor del Subsecretario de Banca de Desarrollo
  Secretaría de Hacienda y Crédito Público

- Alejandro Villagómez
  Director, División de Economía
  Centro de Investigación y Docencia Económicas (CIDE)

- Mario Villalpando Benítez
  Investigador Financiero
  Banco de México

- Gabriela Zapata Alvarez
  Directora
  Proyecto Regional de Asistencia Técnica al Microfinanciamiento Rural (PATMIR)
  Subsecretaría de Desarrollo Rural
  Secretaría de Agricultura, Ganadería, Desarrollo Rural, Pesca y Alimentación